REPORT OF EXAMINATION
OF THE

BALBOA INSURANCE COMPANY

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed June 19, 2007

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Los Angeles, California
May 25, 2007

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

BALBOA INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 3349 Michelson Drive, Suite 200, Irvine, California 92612.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

The examination was conducted concurrently with the examinations of the Company's subsidiary, Meritplan Insurance Company and affiliate, Balboa Life Insurance Company.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

The Company is a wholly-owned subsidiary of Balboa Insurance Group, Inc. (BIG), which is a wholly-owned subsidiary of Countrywide Financial Corporation (CFC). BIG is the holding company for the insurance services group of CFC, which provides agency-related services, property, casualty and life insurance underwriting and reinsurance.

The Company has 30,000 shares of $170 par value common stock authorized and 25,000 shares issued and outstanding which are owned by BIG except for one share which is held by Balboa Life Insurance Company. The Company has no preferred stock authorized, issued or outstanding.

In 2003 and 2004, the Company made cash capital contributions to its wholly-owned subsidiary, Balboa Life & Casualty LLC (BLC), in the amount of $25 million and $28 million, respectively. A review of these transactions disclosed that the Company did not notify the California Department of Insurance (CDI) as required by California Insurance Code (CIC) Section 1215.4(e). CIC Section 1215.4(e) states in part, "that an insurer must keep current the information required to be disclosed in its registration statement (Holding Company Act Form B filings) by reporting all material changes or additions within 15 days after the end of the month in which it learns of each change or addition." Material transactions, for purpose of this CIC Section, are defined as one-half of one percent of the insurer's admitted assets as reported in the December 31st prior annual statement. Based on this criterion, these transactions constituted material transactions. Therefore, it is recommended that for all future periods, the Company comply with CIC Section 1215.4(e), and report all material transactions to the CDI.

In September 2005, CFC contributed $75 million in cash to BIG, which subsequently contributed $75 million in cash to the Company.

In November 2005, BLIC paid a $45 million extraordinary dividend to its immediate parent, BIG. The extraordinary dividend distribution was approved by the CDI on November 10, 2005 pursuant to CIC Section 1215.5(g). At the same time, BIG contributed $45 million in cash and securities to the Company.

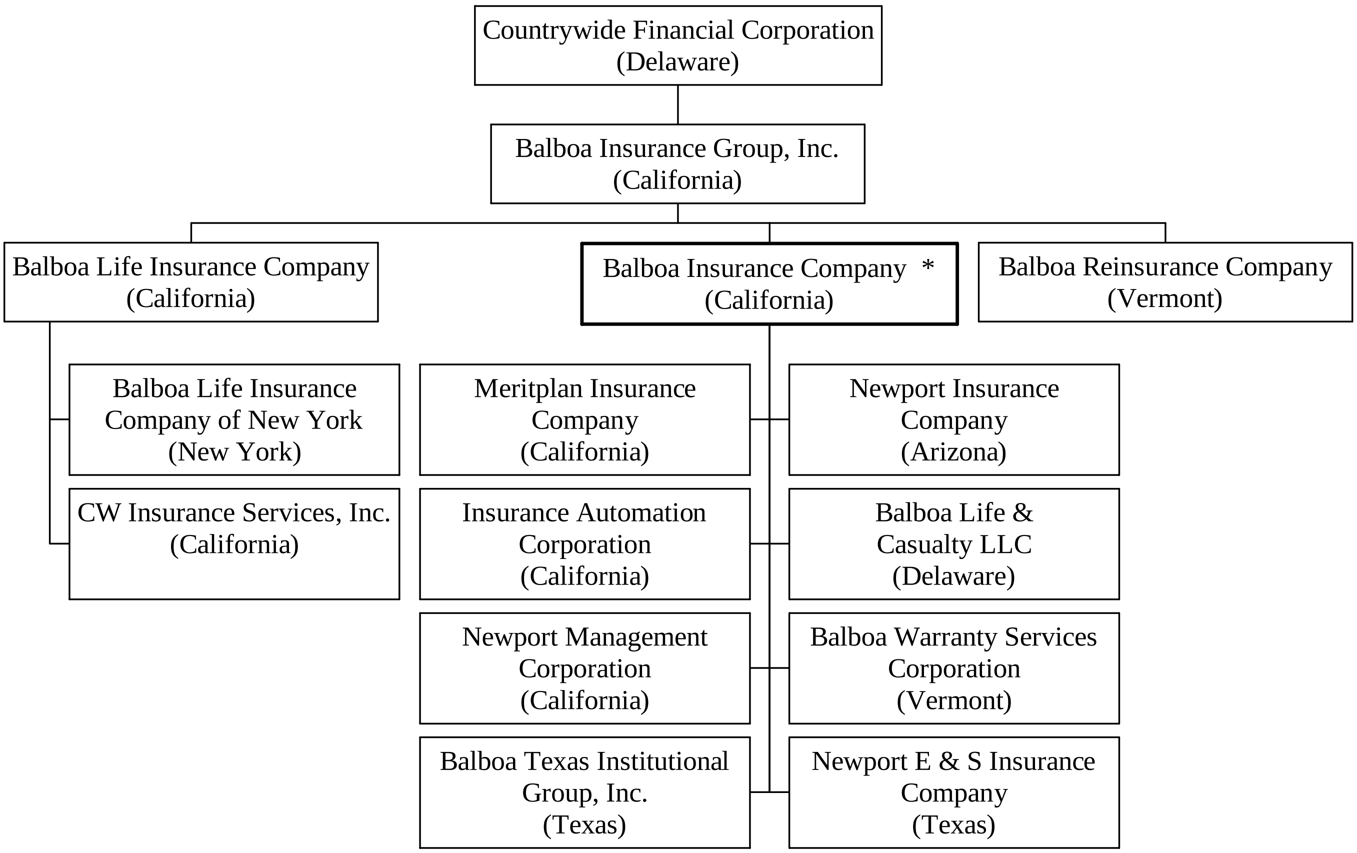
In April 2006, CFC contributed $10 million in cash to BIG, which subsequently contributed $10 million in cash to the Company.

In September 2006, BLIC paid a $30 million extraordinary dividend to its immediate parent, BIG. The extraordinary dividend was approved by the CDI on September 21, 2006 pursuant to CIC Section 10530. Simultaneously, BIG contributed $30 million in cash and securities to the Company. The Company, in turn, contributed the $30 million in cash and securities to its subsidiary, Meritplan Insurance Company.

In April 2007, the Company contributed $7.5 million in cash to its subsidiary, Balboa Warranty Services Corporation.

MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiary and affiliated insurance companies, depicts the Company's relationship within the holding company system: (all ownership is 100%, except as noted below)



(*) Balboa Life Insurance Company owns one share of stock out of 25,000 issued and outstanding shares of the Company

Management of the Company is vested in a seven-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

Name and Residence	Principal Business Affiliation
Carlos M. Garcia Hidden Hills, California	Executive Managing Director, Chief of Bank and Insurance Operations Countrywide Financial Corporation
Andrew Gissinger III Calabasas, California	Senior Managing Director, Chief Production Officer Countrywide Home Loans
Robert V. James Dana Point, California	Senior Managing Director, President and Chief Operating Officer Balboa Insurance Group
Richard S. Lewis Chatsworth, California	Executive Vice President, Chief Administrative Officer Balboa Insurance Group
Mark A. McElroy Santa Ana, California	Managing Director Balboa Insurance Group
Thomas M. Scrivener Camarillo, California	Managing Director, Financial Analysis and Administration Countrywide Financial Corporation
Howard B. Wexler Dana Point, California	Managing Director, General Counsel Diversified Operations Countrywide Financial Corporation

Principal Officers

Name	Title
Robert V. James	President, Chief Operating Officer and Chief Executive Officer
Franklin T. Dunn	Executive Vice President, Secretary and General Counsel
Ronald A. Closser	Executive Vice President, Personal Lines
Mark A. McElroy	Executive Vice President, Lender Placed Lines
David A. Kuhn	Executive Vice President, Commercial Lines Brokerage

Name	Title
Kenneth L. Mertzel	Executive Vice President, Chief Financial Officer
Richard S. Lewis	Executive Vice President, Chief Administrative Officer
Craig L. Carson	Executive Vice President, Marketing
Laurie A. Fitzgerald	Executive Vice President, Chief Accounting Officer

Management Agreements

Administrative Services Agreement: Effective January 1, 2001, Balboa Life & Casualty LLC (BLC) entered into an Administrative Services Agreement with the Company, Balboa Life Insurance Company (BLIC), Meritplan Insurance Company (MIC), Newport Management Corporation (NMC), Newport Insurance Company (NIC), and Insurance Automation Corporation (IAC). Under the terms of the agreement, BLC provided all human resources, underwriting, legal services, actuarial services, claims adjusting and payment assistance, facilities, accounting functions, computer resources, and marketing functions. The companies reimbursed BLC for the actual cost of these services. The California Department of Insurance (CDI) approved this agreement on May 16, 2001. For 2003, 2004, and 2005, the Company paid BLC $84.3 million, $95.5 million and $108.7 million, respectively.

On December 31, 2005, the Company terminated the above Administrative Services Agreement, and entered into a Balboa Insurance Group Intercompany Services Agreement (Intercompany Services Agreement) effective January 1, 2006. The Intercompany Services Agreement is between the Company, and BLC, BLIC, MIC, NMC, NIC, IAC, Balboa Life Insurance Company of New York (BLICNY), Newport E&S Insurance Company, Balboa Warranty Services Corporation, Countrywide Insurance Services, Inc. (CIS), Countrywide Insurance Services of Arizona, Inc. (CIS-AZ), Countrywide Insurance Services of Texas, Inc. (CIS-TX), DirectNet Insurance Agency, Inc. (DirectNet), and DirectNet Insurance Agency of Arizona, Inc. (DirectNet-AZ), collectively known as the Group Members.

Under the terms of the new Intercompany Services Agreement, the Company now provides the information systems services, EDP, accounting and financial functions, underwriting, claims adjusting and payment processing, legal services, actuarial services, and marketing functions. The Group Members reimburse the Company for the actual cost of these services. BLC continues to provide the Group Members with payroll services and facilities based on actual cost. BLIC, NMC, CIS and DirectNet also provide some miscellaneous services to the Group Members on an actual cost basis.

The new Intercompany Services Agreement was entered into to consolidate all service agreements into one agreement. The new Intercompany Services Agreement also specifically identifies the services being provided to affiliated insurance companies. Since BLC still acts as payroll agent for the Group Members, the Company continues to reimburse BLC. In 2006, the Company paid BLC $100.5 million. The CDI approved this agreement on February 27, 2006.

Investment Management Agreement: Effective April 17, 2000, the Company, BLIC, MIC, NIC and IAC entered into an Investment Management Agreement with an affiliate, Countrywide Home Loans, Inc. (CHL). In accordance with the Company’s investment guidelines, CHL provides investment management services and is compensated based on actual expenses incurred. The CDI approved this agreement on November 2, 2000. For 2003, 2004 and 2005, the Company paid $1.06 million, $970,383 and $1.04 million, respectively, in investment and miscellaneous fees to CHL under the terms of this agreement.

Consolidated Federal Income Tax Allocation Agreement: The Company is a party to a Consolidated Federal Income Tax Allocation Agreement with affiliates and its ultimate parent, Countrywide Financial Corporation (CFC). Under the terms of this agreement, the companies file a consolidated federal income tax return. The consolidated federal income tax liability is allocated between the companies in the ratio that each company’s separate tax return liability bears to the total consolidated federal tax liability. This agreement was entered into and approved by the CDI on November 2, 2000. For 2003, 2004 and 2005 the Company paid $4.4 million, $4.2 million and $19.2 million, respectively, in income tax to CFC under the terms of this agreement.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact multiple lines of property and casualty insurance. The Company is licensed to write in all states except Louisiana (surplus lines only) and in the District of Columbia, Guam, U.S. Virgin Islands, Canada, and the Northern Mariana Islands. Of the $503.7 million in direct premiums written in 2005, approximately $105.3 million or 21% was written in California, $58.1 million or 11.5% was written in Florida and $25 million or 5% was written in Pennsylvania.

The Company specializes in lender placed and personal lines insurance distributed through financial institutions and agents including property and automobile collateral protection, homeowners and auto physical damage and liability. The principal lines of business written are automobile physical damage, homeowners, fire, allied, private passenger automobile liability, inland marine and credit. In total, the principal lines of business represent approximately 95.8% of the Company's direct premiums written in 2005.

Business is primarily marketed and produced through a combination of agencies affiliated with the Company as well as financial institutions, general and independent agents. Countrywide Insurance Services, an affiliated general agent, is the largest producer.

Effective August 1, 2004, the Company, Meritplan Insurance Company (MIC), Newport Insurance Company (NIC), and Newport E&S Insurance Company (collectively known as the Companies) entered into an agency agreement with Arrowhead General Insurance Agency, Inc. (Arrowhead). Under the terms of the agreement, Arrowhead has the authority to accept applications and to issue homeowners and automobile insurance policies on behalf of the Companies. As compensation, Arrowhead receives an advance commission and a contingent commission based on loss experience.

Effective April 28, 2005, the Company, MIC, and NIC (collectively known as the Balboa Group) entered into an agency agreement with Carnegie Agency, Inc. (Carnegie). Under the agreement, Carnegie has the authority to accept applications and to issue California automobile insurance policies on behalf of the Balboa Group. As compensation, Carnegie receives an advance commission and a contingent commission based on earned premiums.

In 2006, Carnegie became a managing general agent (MGA) as defined under California Insurance Code (CIC) Section 769.81(c). Due to this change in the relationship and pursuant to CIC Section 769.84(f), the Company was required within 30 days to notify the California Department of Insurance (CDI) and Carnegie of its MGA status. The Company did not comply with this requirement. However, the Company did notify the CDI and Carnegie of the MGA status of Carnegie on February 13, 2007. It is recommended that the Company and Carnegie fully comply with the provisions of the Managing General Agents Act (CIC Sections 769.80 through 769.87).

Effective July 1, 2005, the Company entered into an agency agreement with Asurion Insurance Services, Inc. (Asurion). Under the terms of the agency agreement, Asurion has the authority to accept applications and to issue inland marine policies on behalf of the Company. The inland marine policies specifically provide insurance for lost, stolen and damaged cell phones. As compensation, Asurion receives a commission per covered subscriber. The Company cedes 100% of this business to Mill River Re Limited (25%) and to Exchange Indemnity Company (75%).

During 2005 and 2006 Arrowhead, Carnegie and Asurion produced a total of $167 million and $351.5 million, respectively, in direct written premiums for the Company.

Effective June 1, 2005, the Balboa Group entered into a Strategic Alliance Agreement (Alliance Agreement) with Atlantic Mutual Insurance Company and Centennial Insurance Company (Atlantic Mutual Group). The Alliance Agreement was entered into by the Balboa Group in order to expand its personal lines of business in 13 midwestern and eastern states (excluding Florida) and including the District of Columbia. The Atlantic Mutual Group provides the Balboa Group with its expertise in the marketing of high-value homeowners’ policies. In addition, the Balboa Group continues to re-underwrite and price this business. A further discussion of the Alliance

Agreement is included in the "Growth of the Company" and "Reinsurance" sections of this Report of Examination.

GROWTH OF COMPANY

The Company has experienced significant growth since the last examination through 2006 as shown in the following schedule:

Year	Admitted Assets	Surplus As Regards Policyholders	Direct and Assumed Premiums Written	Net Premiums Written	Net Income / (Loss)
2002	$ 692,138,501	$ 306,858,849	$ 530,234,749	$ 498,917,340	($ 19,527,824)
2003	846,817,702	339,113,096	652,816,391	614,120,004	32,908,533
2004	896,533,881	336,444,372	656,312,583	609,484,565	35,840,241
2005	1,297,172,853	474,705,890	1,005,306,916	813,709,918	4,492,802
2006	1,533,166,926	656,040,225	1,304,332,888	885,459,937	115,516,407

From 2002 through 2006, admitted assets have increased 122%; surplus as regards policyholders has increased 114%. Direct and assumed as well as net premiums written have increased 146% and 78%, respectively. In addition, the Company reported an aggregate net income of $169 million for this same period.

The Company's significant growth is primarily the result of the previously discussed Strategic Alliance Agreement with the Atlantic Mutual Group and the agency agreements with Arrowhead General Insurance Agency, Inc. (Arrowhead), Carnegie Agency, Inc. (Carnegie), and Asurion Insurance Services, Inc. (Asurion). The Strategic Alliance Agreement resulted in direct and assumed premiums written increasing from 2005 to 2006 by approximately $81.8 million or 19% in the fire and homeowners multiple peril lines of business. Business written through the agency agreements with Arrowhead and Carnegie consisted of private passenger automobile liability and physical damage insurance. Direct and assumed premiums written increased from 2005 to 2006 by approximately $73.3 million or 21% for these lines of business. The agency agreement with

Asurion consisted of inland marine business in which direct and assumed premiums written increased from 2005 to 2006 by approximately $134 million or 263%.

It was also noted that the Company's underwriting expense ratios, as a percentage of net premiums earned, have been high for the last five years. From 2002 through 2006, the expense ratios have ranged from 37.8% to 46.1%. The high ratios, according to the Company, are due to the high commission rates associated with certain agents and investments by the Company in its infrastructure to support the substantial growth.

REINSURANCE

Intercompany Pooling Agreement

The Company entered into a Property and Casualty Companies Pooling Agreement (Pooling Agreement) with its subsidiaries, Meritplan Insurance Company (MIC) and Newport Insurance Company (NIC). Under the terms of the Pooling Agreement, all business written by the Company, MIC and NIC is pooled. The pooled premiums, losses, and expenses are reapportioned and shared by the three companies, 92% for the Company, 4% for MIC and 4% for NIC. The pooling agreement was approved by the California Department of Insurance (CDI) on April 4, 2005, effective January 1, 2005.

Assumed

The majority of the Company's assumed business is a result of the Pooling Agreement and the previously mentioned Strategic Alliance Agreement (Alliance Agreement) with Atlantic Mutual Insurance Company and Centennial Insurance Company (Atlantic Mutual Group), effective June 1, 2005.

Of the $501.6 million in premiums assumed in 2005, $346 million or 68.9% relates to the Pooling Agreement and $109.8 million or 21.9% relates to the Alliance Agreement. Under the terms of the Alliance Agreement, the Company assumed certain in-force and new and renewal policies of the Atlantic Mutual Group. In-force policies were assumed through a Portfolio Transfer Agreement (PTA) effective June 1, 2005. Under the terms of the PTA, the Company assumed, on a quota share basis, 50% of the gross liabilities and obligations of the Atlantic Mutual Group as of the effective date. All losses incurred prior to the effective date of the PTA are excluded. New and renewal policies are assumed through a New and Renewal Treaty, effective June 1, 2005. Under the New and Renewal Treaty, the Company assumes 100% of certain Atlantic Mutual Group policies on or after the effective date.

Effective March 1, 2006, the Company amended and restated the Alliance Agreement to assume 100% of in-force, new and renewal policies of the Atlantic Mutual Group.

The Company also assumes a small portion of business from Lloyds of London on selected lender-placed fire insurance policies.

The Company reported assumed liabilities totaling $372 million as of year-end 2005 of which 75% related to the Pooling Agreement. As of year-end 2006, the Company reported assumed premiums and liabilities of $611 million and $361 million, respectively.

Ceded

The largest net amount retained by the Company is $1 million on any one risk for property and casualty lines. The following is a summary of the principal reinsurance agreements in force as of December 31, 2005:

Type of Contracts	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
Property – Excess of Loss			
First Property Excess of Loss	Various/Authorized and Unauthorized	$1 million per risk	$4 million excess of $1 million (1)
Second Property Excess of Loss	Various/Authorized and Unauthorized	None	$10 million excess of $5 million (1)
Casualty – Excess of Loss			
First Casualty Excess of Loss	Various/Authorized and Unauthorized	$1 million per risk	$4 million excess of $1 million (2)

(1) Not to exceed $10 million as respects any loss occurrence involving two or more risks.
(2) Not to exceed $4 million as respects any one loss occurrence or $8 million in all during the term of the agreement.

As part of the Alliance Agreement, the Company retrocedes 50% of the assumed business to Atlantic Mutual Insurance Company (Atlantic Mutual), through a retrocession agreement. In addition, the Company cedes its direct business related to this Alliance Agreement to Atlantic Mutual under the terms of a 50% quota share reinsurance agreement. As of year-end 2005 and 2006, the total reinsurance recoverables related to this Alliance Agreement was $32.5 million and $70.5 million, respectively.

The Company also has a 100% quota share reinsurance (fronting) agreement, effective July 1, 2005, covering its inland marine business relating to lost, stolen or damaged cell phones. The Company cedes 25% of this business to Mill River Re Limited (Mill River) and 75% to Exchange Indemnity Company (EIC). As stated in the contract and due to both companies being non-admitted reinsurers in California, the Company required Mill River and EIC to maintain collateral equal to the total liabilities assumed under this agreement. As of year-end 2005, the total reinsurance recoverables under the terms of this agreement was $12.3 million. The trust account assets held as collateral at year-end 2005 was $16 million. As of year-end 2006, the total reinsurance recoverable was $15.1 million and the total trust account balance was $22.9 million.

In addition, effective January 1, 2004, the Company entered into a fronting agreement with Yosemite Insurance Company. The coverage is for lender placed (residential and commercial real property) and creditor placed (motor vehicle) insurance policies. As of year-end 2005, the total ceded premiums and reinsurance recoverables were $13.4 million and $7.7 million, respectively.

The Company also has two additional immaterial fronting agreements with Amex Assurance Company and Gentle Winds Reinsurance, Ltd. (in run-off).

Effective January 1, 2007, new or amended fronting agreements are subject to the requirements of California Code of Regulations (CCR) Title 10, Section 2303.15(b), which requires insurers to retain 10% of direct premiums written per line of business.

The above mentioned 50% retrocession, 50% and 100% quota share cessions, along with other property and casualty reinsurance cessions in force, are reflected in the following table:

Type of Contract	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
Other Property/Casualty Reinsurance Treaties			
50% Quota Share Homeowners, Auto, Umbrella, Valuables, Watercraft and Other	Atlantic Mutual Insurance Company	50%	50%
50% and 57.5% (depending on the producer) Quota Share Lender Placed Commercial Fire *	Lloyds of London	42.5% and 50% (depending on the producer)	50% and 57.5% (depending on the producer)
65% Quota Share Basic Renters	ICOM Limited (Bermuda)	35%	65%
66.5% (in run-off) Quota Share Leased Equipment	The Equipment Lease Reinsurance Company	33.5%	66.5%

Type of Contract	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
70% Quota Share Leased Equipment	The Equipment Lease Reinsurance Company	30%	70%
90% Quota Share Home Rebound *	Triton Insurance Company	10%	90%
100% Quota Share AD&D *	Amex Assurance Company	0%	100%
100% Quota Share Guaranteed Auto Protection	Gentle Winds Reinsurance, Ltd.	0%	100%
100% Quota Share Inland Marine *	Mill River Re Limited (Bermuda) Exchange Indemnity Company	0%	25% 75%
100% Quota Share Lender and Creditor Placed *	Yosemite Insurance Company	0%	100%

* Deficiencies noted in special termination clause.

Of the nine other property/casualty reinsurance treaties noted in the previous schedule, five had deficiencies in the special termination clause. These agreements allow either party to terminate the agreement due to the insolvency of the other party. This termination article does not comply with the requirements of Statements of Statutory Accounting Principle (SSAP) 62, Paragraph 7 which states, in part, that "reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the reporting entity, nor grounds for retroactive revocation or retroactive cancellation of any contracts of the reporting entity." It is recommended that the Company amend its reinsurance agreements to comply with the requirements of SSAP 62, Paragraph 7.

For property losses from a single occurrence such as earthquakes or hurricanes, the Company purchases property catastrophe excess reinsurance. For any one occurrence, the Company retains the liability for the first $25 million of paid losses. For aggregate losses that exceed $25 million for one occurrence, the coverage provided by the property catastrophe excess reinsurance is summarized as follows:

Type of Contract	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
Property – Catastrophe			
First Property Catastrophe Excess of Loss	Various/Authorized and Unauthorized	$25 million per occurrence	$25 million excess of $25 million (1)
Second Property Catastrophe Excess of Loss	Various/Authorized and Unauthorized	None	$75 million excess of $50 million (2)
Third Property Catastrophe Excess of Loss	Various/Authorized and Unauthorized	None	$150 million excess of $125 million (3)
Third Event Catastrophe Excess	Various/Authorized and Unauthorized	$25 million occurrences (4)	$25 million
Blanket Catastrophe Aggregate Stop Loss	Tokio Millennium Re Ltd (Bermuda)	$30 million per occurrence	$35 million excess of $30 million

(1) Not to exceed $50 million in the aggregate during the term of the contract.
(2) Not to exceed $150 million in the aggregate during the term of the contract.
(3) Not to exceed $300 million in the aggregate during the term of the contract.
(4) Covers third occurrence after hurricanes Katrina and Wilma.

For its entire reinsurance ceded program as of year-end 2005, the Company reported total ceded premium and reinsurance recoverables of $191.6 million and $169.9 million, respectively. As of year-end 2006, the Company reported $418.9 million and $175.1 million, respectively.

ACCOUNTS AND RECORDS

The previous examination disclosed that the Company's assets were commingled with assets of its affiliates. In an effort to resolve this issue, the Company entered into an Intercompany Pooling Agreement (Pooling Agreement) with its affiliates, Meritplan Insurance Company and Newport Insurance Company. Under the terms of the Pooling Agreement, the Company is authorized to collect premiums on behalf of all parties to the Pooling Agreement.

During the course of this examination, it was noted that premium receipts on certain property and casualty business written by the Company and its affiliates are remitted directly to Balboa Life Insurance Company (BLIC), an affiliated life insurance company. On a monthly basis, BLIC allocates the cash receipts back to the appropriate company. Since BLIC is not a party to the Pooling Agreement, it is recommended that the Company and BLIC change these procedures so that premium receipts not associated with the Pooling Agreement are remitted directly to the company that issued the policy.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Statement of Financial Condition
as of December 31, 2005

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 872,607,823	$	$ 872,607,823	
Stocks:				
Common stocks	86,835,234		86,835,234	
Cash and short-term investments	87,870,965		87,870,965	
Other invested assets	25,232,183		25,232,183	(1)
Receivable for securities	183,580		183,580	
Investment income due and accrued	7,365,955		7,365,955	
Premiums and considerations:				
Premiums and agents' balances in course of collection	38,687,759	1,963,524	36,724,235	
Deferred premiums, agent's balances and installments booked but deferred and not yet due	85,689,880		85,689,880	
Reinsurance:				
Amounts recoverable from reinsurers	28,596,265		28,596,265	
Net deferred tax asset	45,217,842		45,217,842	
Guaranty funds receivable or on deposit	4,740,523		4,740,523	
Furniture and equipment, including health care delivery assets	27,815	27,815		
Receivable from parent, subsidiaries and affiliates	15,187,928		15,187,928	
Aggregate write-ins for other than invested assets	25,325,934	24,405,494	920,440	
Total assets	$1,323,569,686	$ 26,396,833	$ 1,297,172,853	

Liabilities, Surplus and Other Funds			
Losses		$ 151,156,035	(2)
Reinsurance payable on paid loss and loss adjustment expense		24,036,081	
Loss adjustment expenses		41,864,694	(2)
Commission payable, contingent commission and other similar charges		3,958,248	
Other expenses		10,217,133	
Taxes, licenses and fees		8,062,344	
Current federal and foreign income taxes		38,142,358	
Unearned premiums		486,967,891	
Advance premiums		3,522,705	
Ceded reinsurance premiums payable		26,733,487	
Funds held by company under reinsurance treaties		5,165,691	
Provision for reinsurance		3,191,335	
Payable to parent, subsidiaries and affiliates		12,998,840	
Aggregate write-ins for liabilities		6,450,121	
Total liabilities		822.466.963	
Common capital stock	$ 4,250,000		
Gross paid-in and contributed surplus	310,189,664		
Unassigned funds (surplus)	160,266,226		
Surplus as regards policyholders		474,705,890	
Total liabilities, surplus and other funds		$ 1,297,172,853	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income		
Premiums earned		$ 681,946,137
Deductions:		
Losses incurred	$ 339,417,140	
Loss expense incurred	64,470,054	
Other underwriting expenses incurred	294,739,823	
Aggregate write-ins for underwriting deductions	(12,650,000)	
Total underwriting deductions		685,977,017
Net underwriting loss		(4,030,880)
Investment Income		
Net investment income earned	$ 33,872,002	
Net realized capital gains	485,586	
Net investment gain		34,357,588
Other Income		
Net loss from agents' or premium balances charged off	$ (885,948)	
Finance and service charges not included in premiums	4,540	
Aggregate write-ins for miscellaneous income	(4,142,263)	
Total other income		(5,023,671)
Net income before federal and foreign income taxes		25,303,036
Federal and foreign income taxes incurred		20,810,234
Net income		$ 4,492,802

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		$ 336,444,372
Net income	$ 4,492,802	
Net unrealized capital gain	3,840,150	
Change in net deferred income tax	16,326,039	
Change in nonadmitted assets	(6,870,589)	
Change in provision for reinsurance	(1,203,209)	
Surplus Adjustment: Paid-in	120,000,000	
Aggregate write-ins for gains in surplus	1,676,325	
Change in surplus as regards policyholders		138,261,518
Surplus as regards policyholders, December 31, 2005		$ 474,705,890

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2002, per Examination			$ 306,858,849
Net income	$ 73,241,576	$	
Net unrealized capital loss		28,964,221	
Change in net unrealized foreign exchange capital gain	409,671		
Change in net deferred income tax	23,680,216		
Change in nonadmitted assets		19,303,191	
Change in provision for reinsurance		2,893,335	
Surplus adjustments: Paid-in	120,000,000		
Aggregate write-ins for losses in surplus	1,676,325		
Totals	$ 219,007,788	$ 51,160,747	
Net increase in surplus as regards policyholders			167,847,041
Surplus as regards policyholders, December 31, 2005, per Examination			$ 474,705,890

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Other Invested Assets

The above captioned asset consists entirely of the Company's equity in its wholly-owned subsidiary, Balboa Life & Casualty LLC (BLC). The Company reported BLC in its financial statements at a book value of $25.2 million as of year-end 2005 in accordance with the National Association of Insurance Commissioners' (NAIC) Securities Valuation Office (SVO) equity method. Although the Company properly valued BLC in its financial statements, it did not comply with the reporting requirements of the NAIC SVO Policies and Procedures Manual, Part 8, Section 1, which requires the Company to report this investment to the SVO within 30 days of its acquisition or formation. It is recommended that the Company comply with this requirement and report this investment. On April 19, 2007, the Company reported this investment to the NAIC SVO.

(2) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance (CDI), the Company's loss and loss adjustment expense reserves as of December 31, 2005 were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Company History (Page 2): It is recommended that for all future periods, the Company comply with CIC Section 1215.4(e), and report all material transactions to the CDI.

Territory and Plan of Operation (Page 8): It is recommended that the Company and Carnegie Agency, Inc. fully comply with the provisions of the Managing General Agents Act (CIC Sections 769.80 through 769.87).

Reinsurance (Page 11): It is recommended that the Company amend its reinsurance agreements to comply with the requirements of Statements of Statutory Accounting Principles (SSAP) 62, Paragraph 7.

Accounts and Records (Page 17): It is recommended that the Company and Balboa Life Insurance Company change their procedures so that premium receipts not associated with the Pooling Agreement are remitted directly to the company that issued the policy.

<u>Previous Report of Examination</u>

Management and Control – Management Agreements (Page 5):

(1) It was recommended that the Company prepare and maintain written procedures on how allocations are to be made under the terms of the Administrative Services Agreement. The Company has complied with this recommendation.

(2) It was recommended that the Company prepare and maintain documentation that would provide a complete audit trail from the actual expenses incurred by the entity providing the services to the reimbursement of these amounts by the companies receiving these services. The Company has complied with this recommendation.

(3) It was recommended that the Company provide the CDI with a complete and thorough explanation of the nature and purpose of BLC. The Company has complied with this recommendation.

(4) It was recommended that the Company amend the Administrative Services Agreement and any future agreements when changes are made to the original approved agreement. Also, the Company should submit the amendment to the CDI for approval. The Company has complied with this recommendation.

(5) It was recommended that the Company comply with CIC Section 1215.4(e) and report all transactions with BLC to the CDI. As previously noted, the Company still has not complied with this recommendation. In addition, to satisfy the requirements of CIC Section 1215.1(b)1 and to qualify the $25 million contribution as an authorized investment, BLC must issue securities to evidence ownership. The Company has complied with this recommendation.

Accounts and Records – Commingling of Assets (Page 12): It was recommended that the Company and its affiliates change their procedures so that premium receipts are remitted directly to the company that wrote the premium. The Company still has not fully complied with this recommendation.

Accounts and Records – Amendments to Financial Statements (Page 13): It was recommended that the Company implement controls to detect errors and properly review the statutory financial statements before they are submitted to the CDI. The Company has complied with this recommendation.

Receivables for Securities (Page 17): It was recommended that the Company comply with SSAP 27, paragraph 7 and 8. The Company has complied with this recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the officers and employees of Balboa Life & Casualty LLC during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Duane Armstrong, CFE
Examiner-In-Charge
Senior Insurance Examiner, Supervisor
Department of Insurance
State of California